

IRS issues proposed regulations relating to deferred compensation

On September 29, 2005, the IRS issued proposed regulations under Code §409A [www.treasury.gov/press/releases/reports/reg15808004.pdf]. As discussed in our prior *Cooley Alerts*,¹ §409A covers a wide range of nonqualified deferred compensation plans and arrangements and imposes a number of strict requirements that such plans and arrangements must satisfy in order for participants to avoid immediate taxation, an additional 20% tax, and interest on underpayments of tax.

Because the proposed regulations are over 200 pages long, the following discussion can only summarize some of the more important provisions. We intend to circulate a more extensive Cooley Alert shortly and also will devote one of the break-out sessions at our upcoming HR Network programs to the proposed regulations.

Nonqualified stock options (“NSOs”)

Prior guidance under §409A, IRS Notice 2005-1, makes clear that an NSO must have an exercise price that is at least equal to the fair market value of the underlying stock on the date of grant in order to avoid the application of §409A to the option. The Notice also provides that the company is required to use a “reasonable” valuation method in determining fair market value for this purpose.

The proposed regulations address the valuation of stock for purposes of setting the exercise price on NSOs. The regulations include valuation guidance for readily tradeable stock and illiquid “start-up corporation”

stock. For companies falling outside either of these two categories, the regulations set forth a list of factors that will be considered in determining whether a valuation is reasonable. Privately-held companies will want to review their current valuation practices in light of the proposed regulations.

Modifications to options

The proposed regulations describe the circumstances under which an option will be considered modified, thereby resulting in a deemed new grant of the option for purposes of testing whether its exercise price is at least equal to the fair market value of the underlying stock on the grant date. A modification is defined as any change in the terms of the option that may provide the holder with a direct or indirect reduction in the exercise price, an additional deferral feature, or an extension or renewal of the option. However, an option’s exercise period may be extended until the later of: (i) December 31 of the year in which the option would otherwise have expired, or (ii) 2½ months after the date the option would have expired, without causing a modification. This exception was designed to permit extension of an option’s exercise period for terminating employees. In addition, it is not a modification when an option that is not presently exercisable is amended to accelerate the time at which it may be exercised.

Consultants

For purposes of the exception to coverage under §409A for consultants who provide

“significant” services to two or more unrelated clients, the proposed regulations clarify that a consultant will be treated as providing significant services to two or more clients if not more than 70% of the total revenue generated by the consultant’s business is derived from any one client (or group of related clients). The proposed regulations also clarify that service as a director will not make an individual eligible for this exception, and, accordingly, director compensation arrangements will need to take account of the rules under §409A.

Short-term deferral

The proposed regulations confirm and clarify the 2½ month “short-term deferral” exception contained in Notice 2005-1. This exception, which was not certain to be

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extended, has proved extremely helpful in avoiding the application of §409A to a variety of compensation arrangements.

Stock appreciation rights (“SARs”)

While Notice 2005-1 provided SARs with a limited exception from the application of §409A, the proposed regulations expand the types of SARs that may be granted without triggering the adverse consequences of §409A. The exception now includes private company SARs and cash-settled SARs, subject to several requirements.

Severance pay arrangements

The proposed regulations contain numerous new rules related to severance pay and benefits. Many existing severance plans and arrangements will have to be amended to comply with the guidance in the Proposed Regulations.

Distribution events

The proposed regulations expressly permit a deferred compensation plan to provide for payout upon the earlier of, or the later of, two or more specified permissible payout events or times.

Effective date

The proposed regulations are generally applicable for taxable years beginning on or after January 1, 2007, but taxpayers may rely on them immediately. The proposed regulations extend the deadline for documentary compliance with the new rules from December 31, 2005 to December 31, 2006, and also provide for extended transition relief for certain, but not all, aspects of §409A compliance.

Since many compensation arrangements are affected by the proposed regulations, we welcome your inquiries about how the new rules will apply to a particular situation.

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Notes

1 See the following past *Cooley Alerts*:

Nonqualified deferred compensation: new legislation imposes stricter rules and penalties: www.cooley.com/news/alerts.aspx?ID=000038715520

Deferred compensation: initial guidance on the new tax law: www.cooley.com/news/alerts.aspx?ID=000038783320

New deferred compensation tax rules: FAQs: www.cooley.com/news/alerts.aspx?id=38824620